SYSTEMIC SUPPORT FOR EL SALVADOR'S SUPERINTENDENCY OF THE FINANCIAL SYSTEM (SSF): SUPERVISION OF THE SME PORTFOLIO

FINANCIAL SERVICES FOR SMES PROGRAM

April 2008

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EXECUTIVE SUMMARY

The financial system in El Salvador has faced radical changes in its operations in the last three years as a result of processes closely related to globalization. These processes are as follows: acquisition of most financial assets in the country by foreign banks, a boom in the consumption and housing portfolios stemming from remittances sent by their emigrant citizens from the United States and the interest bankers have to diversify their business portfolios towards more profitable and stable segments such as the small and medium-sized enterprises (SMES).

However, the norms and regulations set forth by the financial system's superintendence (SSF) in El Salvador have not kept pace with these changes. Most of its regulations are based on old supervision schemes where there is a deep-rooted distrust about banking institutions in the system. In brief, the system is based on auditing compliance with norms and regulations and not on the knowledge agents and their business have. This is known as supervision by compliance.

Aware of these challenges, the SSF has changed its regulations through Normative NBC-022 in order to somehow ease granting and supervising loan assets. Its main benefits are in increasing from USD 50.000 to 100.00 dollars the amount under which the SSF allows financial institutions to decide based on their internal policies and processes what documents are required to correctly evaluate their clients; recognizing the recovery value of real guarantees through which their value is taken from the asset's value to create or have reserves; and the additional segregation of qualifications to increase the information on the status of debtors.

However, some agents in the system have indicated that in spite of the SSF efforts, the NBC- 022 does not bring about a significant progress in the way the SSF carries out its supervision of financial institutions. They have said that on the contrary, the new regulation increases the number of required documents for business loans granted over the set forth amount, which has definitely affected granting loans to SMES.

Thus, financial institutions say that small enterprises have migrated to other agents not regulated by the SSF, the processing time for granting loans has increased significantly, and a new and important trend to require mortgage guarantees from clients in order to reduce the reserves which need to be kept has emerged. All this has made it difficult for obtaining credit for viable business projects and it has allowed the over-indebtedness of clients with big mortgage guarantees and poorly managed businesses.

Beyond regulatory specificity, we can still perceive great distrust among agents in the financial system. Financial institutions believe that the SSF supervision is obsolete, and it does not reduce the systemic risk and it generates important operational costs. It is also clear that there is certain jealousy towards their competitors which in turn makes any professional dialogue at the Banking Association of El Salvador (ABANZA, in Spanish) very difficult.

On the other hand, the SSF believes that there is a lack of professionalism in the bank's self-regulation systems and it distrusts their risk management criteria.
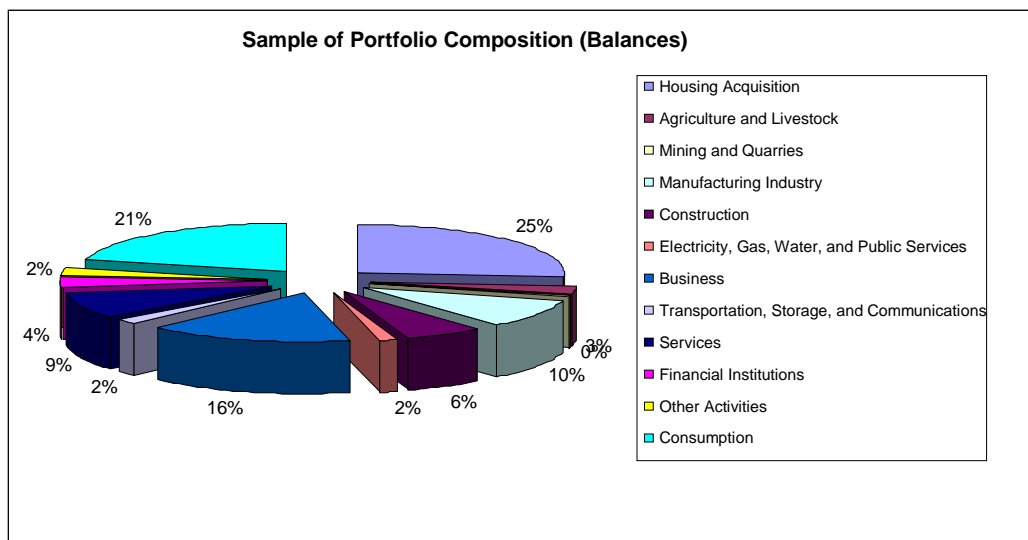
SECTION I. ASSESSMENT OF THE REGULATION AND SUPERVISON OF THE SME PORTFOLIO

1. Context of the Consultancy

Financial System's Status

The banking system in El Salvador is highly concentrated. The main five banks represent 85.5% of the system's assets. Currently, these banks are branches of foreign banks, but these acquisitions are fairly recent, which has created some administrative disorganization. In most of the cases the transfer of the banking technology from their home offices has not occurred yet.

The portfolio is fairly diversified. As shown in the graph below, even though the business portfolio represents close to 50% of the system's credit assets there is no specific sector concentrating the balance of all credits.

Sample of Portfolio Composition (Balances)

- Housing Acquisition
- Agriculture and Livestock
- Mining and Quarries
- Manufacturing Industry
- Construction
- Electricity, Gas, Water, and Public Services
- Business
- Transportation, Storage, and Communications
- Services
- Financial Institutions
- Other Activities
- Consumption

21% 2% 4% 9% 2% 16% 2% 6% 10% 0% 3% 25%

Source: SSF

However, certain banks concentrate larger proportions of these portfolios. One banking institution has almost 50% of the consumption portfolio. Another bank has around 40% of the housing portfolio, and two banking institutions (depending on the sector) hold 80% of the business credit in most of the economic sectors.

Business Portfolio Status

The business portfolio principally focuses on the business, manufacturing, and service sectors. There was no information available that allows us to know what percentage of credit is extended to large business versus microenterprises. However, the banks that were consulted did state that although there have been efforts to increase the level of credit extended to SMES, still the majority of credit is still directed at large businesses.

Sample of Business Portfolio Composition (Balances)

Legend:
- Agriculture and Livestock
- Mining and Quarries
- Manufacturing Industry
- Construction
- Electricity, Gas, Water, and Public Services
- Business
- Transportation, Storage, and Communications
- Services
- Financial Institutions
- Other Activities
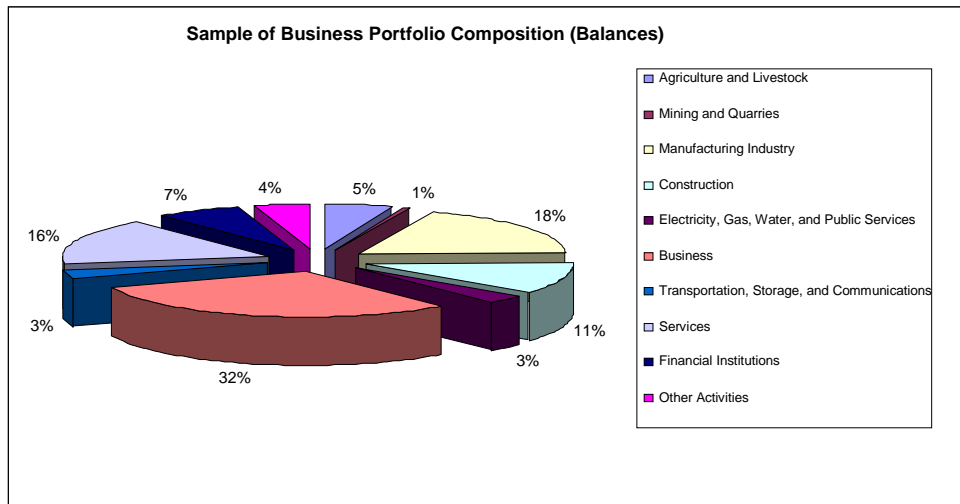
Source: SSF

According to their credit rating, the quality of this portfolio is lower than the rest which contradicts statistical evidence found in other economies with similar characteristics. This may mean a higher control on risk management or excessive regulation (more requirements per category). However, there is no evidence that Norm NBC-022 has affected the quality of this portfolio because in spite of higher category segregation, the same level of debtors in worse risk ratings exists before and after the norm.

These deficient indicators are mainly the result of the poor performance of the credit to the agriculture and livestock (only 50% of the loans are in a better category), the manufacturing industry, and the services sectors.

Business Ratings Composition

Legend:
- A1
- A2
- B
- C1
- C2
- D1
- D2
- E
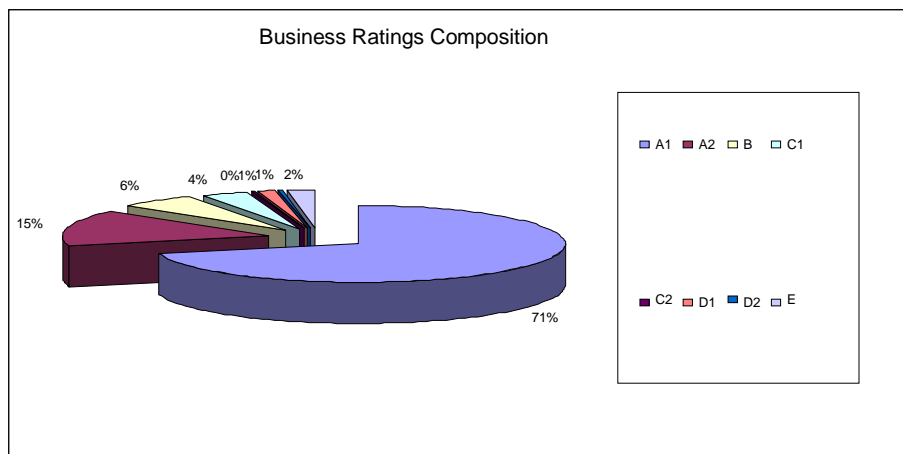
Source: SSF

Housing Portfolio Status

The housing portfolio has experienced an exponential growth due to programs promoting the use of remittances for the acquisition of real estate assets. In most of the banking institutions analyzed, the percentage of new credits granted last year in this mode doubles the traditional percentage of the weight of this portfolio in the bank's assets.

We observed a more lax regulation on housing credit rating (only by default, an important discount in value of the guarantees and longer terms in days in each risk category). This makes this portfolio to have higher quality indicators than those of the business portfolio.

Housing Rating Composition
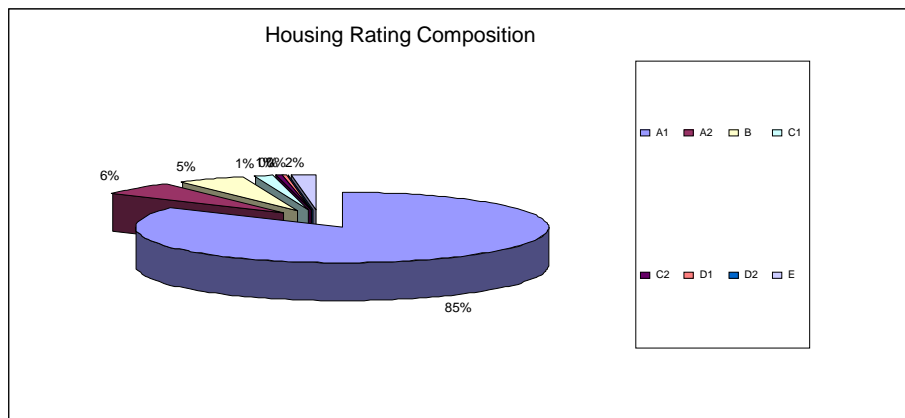
Source: SSF

Consumption Portfolio Status

Some banking institutions are very aggressive in lending in this portfolio (a growth of more than 300%) which could indicate an over-indebtedness problem in the system. However, credit quality indicators are the best of the three portfolios. This could reflect, as seen in the housing portfolio, a less rigorous regulation than that in the business portfolio and an almost exclusive dependency on default.

Consumption Rating Composition
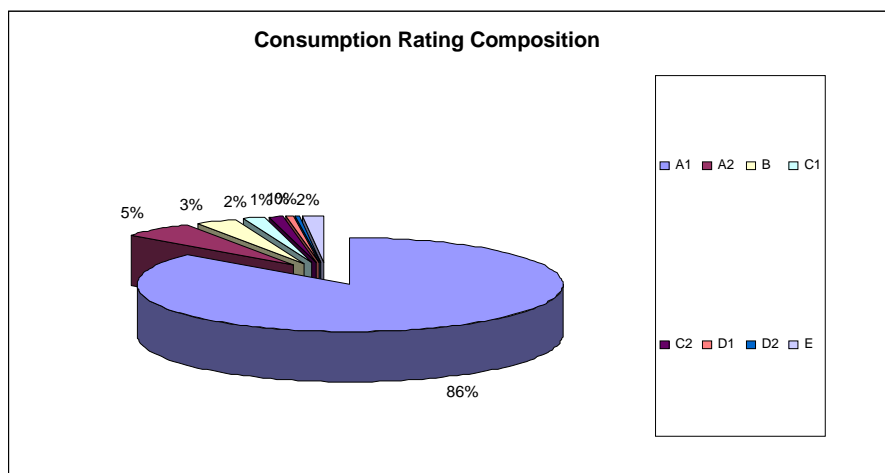
Source: SSF

Recession Fears

All banking institutions surveyed have a clear perception of a future recession in the Salvadoran financial system. The impact of the subprime crisis in the United States which could create an important reduction in the remittances level and the continuous trade balance deficit are the biggest preoccupation factors for bankers. In addition, there is a perception that the system is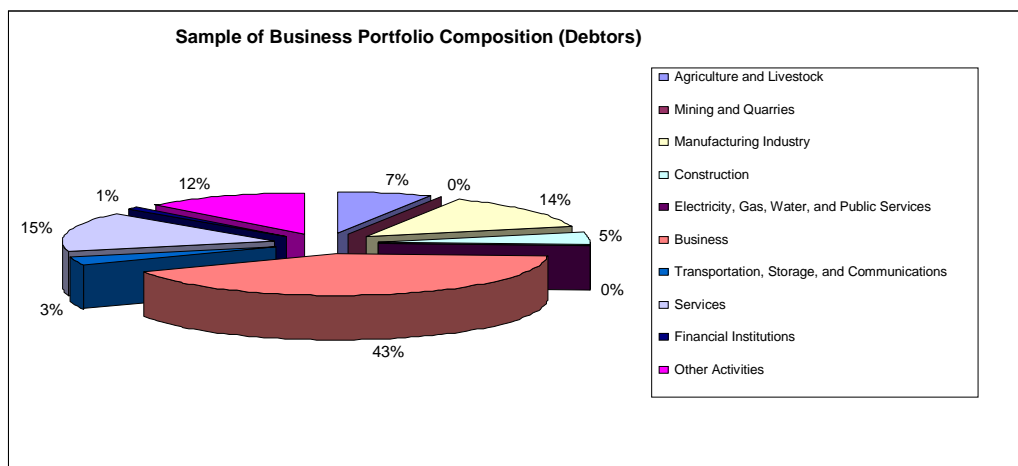 experiencing a speculating bubble in the consumption and housing portfolios even though no banking institution in particular is showing a trend to reduce its exposure to this type of credit, and on the contrary, one can see a trend towards increased lending.

The SMES Portfolio at SSF Regulated Banking Institutions in El Salvador

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The SSF regulation does not have a clear definition of the types of companies on the business portfolio. Moreover, the definition of the business portfolio is not clear and it is limited to providing a definition by exclusion which could lead to having many credits classified as business portfolio that do not really have any productive activity.

In addition, the business categories among the banks surveyed are significantly different. This lack of information makes the SMES portfolio proper and adequate supervision fairly difficult. From available information we can observe that sectors from the business portfolio that have a higher number of debtors are from commerce, manufacturing industry and the services sector. Some of these sectors are traditionally related to the SMEs.

Sample of Business Portfolio Composition (Debtors)

- Agriculture and Livestock
- Mining and Quarries
- Manufacturing Industry
- Construction
- Electricity, Gas, Water, and Public Services
- Business
- Transportation, Storage, and Communications
- Services
- Financial Institutions
- Other Activities

7% 0% 14% 5% 0% 43% 3% 15% 1% 12%

Source: SSF

If we compare the debtor percentage with the debt percentage in the system's assets then we can observe that the sectors with a higher number of debtors in spite of having a lower weight in the assets are the agriculture and livestock sector, the business sector and the

other activities sector. This is consistent with the information provided by the banks contacted.

Another of the SME problems is related to the lack of definition of a commercial credit to individuals. This creates, according to the banking institutions contacted, the existence of a percentage of the SMEs credit that is camouflaged in the consumption portfolio.

Indicator of Number of Debtors against Portfolio Weight
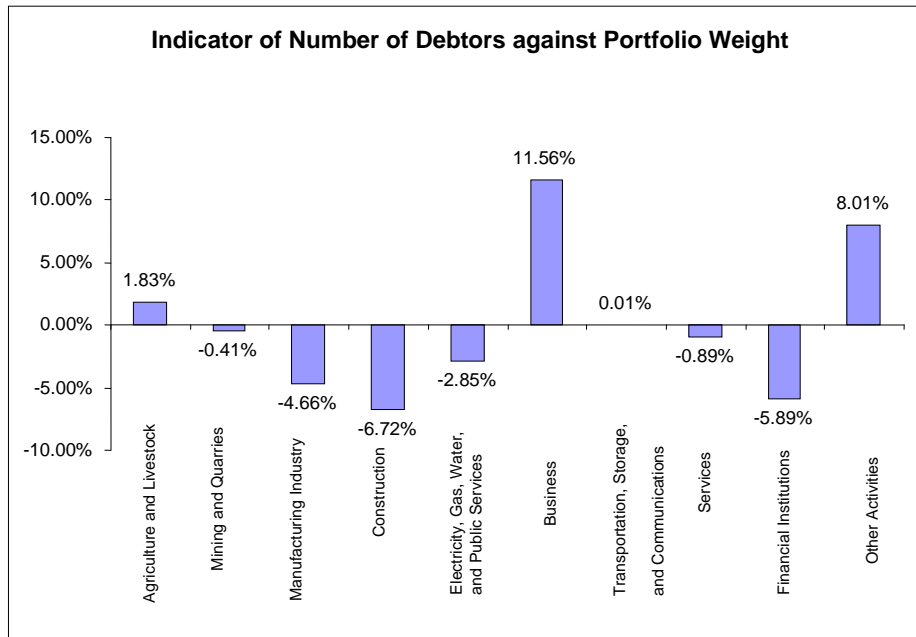
Source: Information from the SSF – Personal calculations

USAID Data

In spite of the fact that the information available at the SSF does not break down the business portfolio per type of enterprise, the USAID Financial Service Program for the SMEs monitors the behavior of this portfolio in its affiliated banks.

The SME portfolio in the banks surveyed represents more than 20 percent of the business portfolio. Out of this, the small enterprise represents, on average, 11 percent (even though in one of the financial institutions it is 28 percent) and the medium-sized enterprise represents 10 percent (the maximum it reaches in one banking institution is close to 15 percent).

From this information we can observe that the average loan amount granted to the small industry is around USD $30,000 and the average loan amount granted to the medium-sized industry is a little bit over USD $100,000.

Average Loan Amount Granted to the SME Portfolio		
	Small	Medium-Sized

Mean	$ 38,019.92	$ 102,776.25
Median	$ 28,893.63	$ 105,355.57
Weighted by portfolio participation	$ 29,167.48	$ 105,975.42

Source: USAID – Personal calculations

On average, 9 percent of all credit granted to small enterprises exceeds USD $100,000, in the case of the medium-sized enterprises this percentage reaches 20 percent.

These data also allow us to measure the default levels for this portfolio and to compare it with the information available from the SSF for the other types of portfolio. As shown on the table below, the SME portfolio presents a lower average default (less than 90 days overdue) than the rest.

Portfolio Type	Default % > 90 days
SME	2.85%
Consumption	4.49%
Business	3.80%
Housing	3.32%
Total portfolio	3.62%

Source: SSF and USAID

Since the SME portfolio weight is not yet significant in the total portfolio and there is a high concentration in certain banking institutions, the traditional default portfolio indicator that the Superintendence uses is well below these average defaults. The previous table shows that if all banking institutions had a similar participation in the portfolio and there was no credit concentration, the SME portfolio would be the one with the best performance.

Benefits of the SME Portfolio

In view of the possibility of a recession affecting the consumption and housing portfolios, banking institutions understand the need to better diversify their risk by increasing their exposure to the SME portfolio. This portfolio has the advantage of standing crises in a better way as a consequence of its lower exposure and scarce debt concentration. In addition, the SME credit analysis is focused on business viability and not on the existence of guarantees as is the case in other portfolios.

SME Risk Management

However, the SME loan and loan-granting and management require a change in the lending technology of banking institutions. This portfolio must be managed knowing its clients and their businesses with a focused follow-up and collection processes, with additional support for the business formalization and management process, with a risk

management focused on understanding the specific variables of each client and an on-going monitoring of their business fundamentals.

This technology is expensive and thus it has involved an important resource investment from all banking institutions in the last years. Support from home offices and the USAID cooperation have allowed sufficient investment to generate a series of banking institutions which have the necessary technology to manage these types of loans.

However, there is still a long way to go for these banking institutions to reach risk schemes matched to international standards in this matter. For the time being, their technology is limited to, in the best case scenario, expert models for granting loans (parametric).

To be able to leap to the Basel II self-regulation schemes themselves, banking institutions must invest in the construction of databases, statistical models for granting and following-up loans, training their staff on risk management (including their managers) and the empowering of the risk teams in the organization (these still have low relevance as compared to their business counterparts and most of the time they only exert auditing work proper for internal control bodies).

SME Portfolio Supervision

As with this portfolio's loan-granting and monitoring, supervision of this type of banking institutions requires a special kind of technology in order to guarantee good performance. Because of the particular conditions of its clients, it is difficult to supervise compliance (that is, ensure that legal and accounting standards are applied); and therefore, it is necessary to move to a risk-focused supervision.

This supervision is greatly based on the self-regulation capacity banking institutions have as the entities knowledgeable about the business of lending money to the SMEs. Thus, the role of supervisory bodies is to check the internal risk schemes being implemented by the banks and then ensure their compliance.

In addition, the supervisory body replicates in its own structure to mirror the scheme of the supervised banking institutions, including having supervisors specialized in the control of credit risks in the SME portfolio. These supervisors are capable of following up and questioning the decisions made by these institutions from the point of view of the risk control of their clients' businesses.

Below is a summary of the main differences between the traditional by-performance supervision and the risk-based supervision:

Supervision by Performance	Risk-based Supervision
Comprehensive orientation	Selective orientation (Main risks, more knowledge about banking institution)

Individual operation review	Comprehensive vision of banking institution (qualitative component)
• Check list (taxing norms), accounting balance • Instructions: Establish the "how" • Supervisor checks and requires	• Specialized supervision ("minimum" norms) importance of expert judgment • SAR parameters "what to do" • Banking institution must show and justify system implementation
Items performed / Observed	Prospective
Communication within visits framework / it is more sanction-oriented	Additional discussion and contact room / more recommendations, less sanctions.
Paternalistic / intromission	First person perspective / "legal age"

> International Change in the Supervision Paradigm and New International Standards (Basel II)

These changes in the supervision schemes to match business variations in banking institutions have modified the operations of supervisory bodies worldwide. Thus, supervision bodies of main economies in the world have made an effort to standardize these new parameters through the International Convergence of Capital Measurement and Capital Standards of 2001, commonly known as Basel II.

Basel II is founded on supervision of banking organizations self-regulation where capital adequacy norms and capital reserves and credit evaluation match the business reality of supervised banking organizations.

In order to measure the amounts of these requirements, one can use statistical models which determine and measure risk variables, generate debtor ratings depending on this risk factor, and quantify the possible impact on the banking organization and worsening of credit assets quality.

These changes in the supervision of banking organizations are significant and have taken several years of effort before they began to be implemented (mainly in Western Europe) in 2008. Several Latin American countries have shown interest in applying the Basel II standards and have developed implementation schedules which vary depending on the internationalization of their banking system and the risk systems of their organizations.

2. SME Portfolio Regulation Experiences in Other Countries and other InternaTional Experiences

Under this new supervision by risk scheme and implementation of the Basel II, some countries have modified their regulations to create a different treatment for the SME portfolio given that its characteristics require a change in its supervision as compared to other types of portfolios.

Basel II

Pragraph 273 of The Basel II Accord provides a definition for the SME portfolio. In this definition it allows banking organization to use internal credit risk measuring systems (IRB) to separate SME credit exposures from the credit exposure of their corporate portfolio. By doing so it defines the SME portfolio as any consolidated exposure less than 50 million Euros and higher than 5 million Euros.

Spain

Spain was one of the first countries to implement Basel II. Based on the Accord recommendations, we can observe a definition of the SME portfolio adjusted to the country's special characteristics, such as:

> ### Chapter on Credit Risk CBE 0401, of 2006
> *2 – Exposures that satisfy the following requisites will be assigned to the retail category: a) if they are exposures to physical individuals or to small or medium-sized enterprises (SMEs). In the SMEs case, it will also be necessary that the total debt amount of the client or group of clients related among them before the credit institution, including any prior exposure which is now delinquent, but excluding all exposures guaranteed with residential real properties, does not exceed 1.000.000 Euros.*

Colombia

The Colombian regulation on loan portfolio supervision is included in Chapter 2 of the Financial and Accounting Basic Form Letter issued by the Financial System of Colombia Superintendence (SSFC).

This regulation includes a special treatment to information requested by the supervisory body for micro-credits, which is described as follows:

> ### 1.3.2.1c. Repayment capacity measurement in loan granting systems
> *"… In the micro-credit case, the information required under this subchapter may be obtained and documented at the place where the activity to be financed takes place…"*

In addition, this same chapter allows a special legal treatment for guarantees provided by the National Guarantee Fund, which is the governmental body specialized in supporting the SMEs.

> ### 1.3.2.1d. Guarantee analysis in loan granting systems
> *"...For the purposes of evaluating credit risk, guarantees provided by the National Guarantee Fund are considered ideal guarantees which satisfy all requirements provided for in this subchapter."*

We also observe a special treatment for SMEs in the reference model for measuring expected losses from the Credit Risk Management System (SARC, in Spanish) which measures the minimum level of capital for banking organizations which do not have an internal model for measuring minimum capital levels.

In it we observe the creation of models specially tailored for the small and medium-sized enterprises.

> ### Annex 3, item 2, Chapter 2, Financial and Accounting Basic Document

> ### 2. Business Portfolio Reference Model
> *Segmentation and discrimination processes for credit portfolios and their potential subjects of credit must be the basis for calculating the expected losses in the MRC. Thus, the business portfolio reference model is based on segments differentiated by the level of assets of the debtors.*
>
> *Portfolios were defined under the following criteria:*

Business Portfolio Rating by Asset Level	
Company Size	*Asset Level*
Large Enterprises	*More than 15,000 SMMLV[1]*
Medium-sized Enterprises	*Between 5,000 and 15,000 SMMLV*
Small Enterprises	*Less than 5,000 SMMLV*

> *In addition, a new category called "individuals" was created where all individuals who are debtors of commercial loans are grouped together.*

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[1] Current Legal Monthly Minimum Salaries

Chile

The Chilean Banking Superintendence has chosen a model where the special treatment for SMEs must match the development of internal supervision system of its banking institutions. Thus, even though it does not modify its original portfolio definitions, it gives banking institutions the responsibility to generate statistical information on the SME portfolio which could be supervised.

> *"Chapter 7, Form Letter 3, of 2002*
> *… for purposes of accounting information provided to this superintendence, a grouping of commercial credits, housing mortgage credits, consumption and leasing and factoring credits will be established considering provisions set forth in Annex No. 2 of this Chapter, without affecting more detailed information that could be requested mainly in relation to the type of commercial credit debtor (large, medium-sized, small and micro-enterprises) or the identification of credits granted to debtors from abroad…"*

The World Bank – International Financing Corporation (IFC)

The World Bank and its business financing unit, the IFC provides the following definition for segmenting its clients' portfolio:

	Micro	**Small**	**Medium-Sized**
Employees	< 10	10 – 50	50 – 300
Total Assets	< USD$ 100,000	USD$ 100 K – 3 M	USD$ 3 M – 15 M
Annual Sales	< USD$ 100,000	USD$ 100 K – 3M	USD$ 3 M – 15 M

3. Current Regulation Assessment

In 2006, the SSF modified its regulations regarding criteria for rating and minimum capital requirements for the portfolio of banking institutions it supervised. Even though the main objective of the new regulations was to increase the capital reserve requirements for banking institutions; increase the requirements for submitting them to the supervisory body; and provide the necessary tools to comply with the new tasks the government had delegated to the SSF (all changes consistent with the supervision by performance mentality), the new regulation (NBC 022 of 2006) brings about important advances in comparison to previous regulations (NBC 003 of 1993).

The main advantages of these changes in view of proper supervision of the SME portfolio are as follows:

1. It allows for self-regulation (including debtor re-classification) over loans granted whose consolidated balance is lower than USD$ 100,000. (NBC -003 established this amount to be just USD $57,000).
2. The norm allows for overdue credits to keep a C rating as long as they had a real property guarantee was eliminated.
3. It increased risk categories and improved guidelines for their rating (minus grey zones).
4. It included general guidelines on policies (proper of a system of supervision by risk) for the first time.

Some banking institutions, however, have indicated their disagreement with this norm and during our interviews with them stated the following points as those elements from the current regulations that harmed the SME portfolio the most:

1. The USD $100,000 amount is too small and limits loan granting to SMEs with higher balances.
2. The SSF demands too many documents to grant loans.
3. It incentivizes the presence of mortgage guarantees on all operations.
4. The SSF does not understand the SME business and supervises it the same way it does large enterprises.

Once this norm is analyzed it is clear that the regulation problems related with the SME loan scoring and capital reserves generation go beyond what banking institutions had indicated. If the SSF wants to properly supervise this type of debtors it must correct the following problems in the current regulations, which considerably affect the SSF's ability to use a scheme of supervision-by-risk:

1. It mixes risk with legal compliance. It makes it difficult for the transition to supervision by compliance and distorts databases for prospective supervision. There are many other tools to enforce the law.
2. Its portfolio definitions are insufficient to supervise banks activities. Broad definitions based on negative lists disguise SMEs credits under other forms.

3. It is too strict on the parameters established for the business portfolio, but too lax on those for the consumption and housing portfolios. This incentivizes more loans on these portfolios.
4. Although it is included in the norm, the SSF does not supervise banking institutions' risk schemes for amounts lower than the set forth amount. This makes banking institutions without proper technology to grant SME loans which could weaken the portfolio.
5. It attempts to increase capital reserves without having a clear measure of what the risk is.

In addition, there are other problems which are not regulatory in essence, affecting the proper operation of the SME credit. If a general effort to improve the banking institutions' risk evaluation systems and the SSF supervision scheme is not made, any regulation modification will be insufficient to solve some of the core problems.

The specific SME portfolio supervision and SSF problems are as follows:

1. Dependence on mortgage guarantees. There are no guarantee funds or risk management systems to allow granting loans without having any guarantees.
2. In spite of recent acquisitions, banking institutions' risk management systems are not strong enough to allow more self-regulation.
3. In spite of recent trends, there is still a trend to favor consumption and housing loans against commercial loans.
4. Mutual distrust between supervisory bodies and supervised banking institutions.
5. Distrust between market agents.
6. There is no permanent dialogue between the SSF and supervised banking institutions.

The problems found in the supervision of the SME Portfolio are as follows:

1. The SSF intends to implement supervision-by-risk, but it has not clearly defined yet how to do the transition.
2. There is a clear trend at the SSF towards measures focused on compliance (higher reserves, stricter controls, more prohibitions)…
3. The SSF does not know most of the businesses of the banking institutions it supervises.
4. The SSF lacks supervisors specialized in risk management for this portfolio.
5. The SSF does not have enough political independence.

SECTION II. PROPOSAL FOR CHANGES TO THE PRUDENTIAL AND ACCOUNTING REGULATION

In view of the fallacies found during the assessment of current norms and regulations regarding the SME credit, we offer the following suggestions:

1. Short Term

1.1 In the Regulatory Area

Eliminate regulation requirements as risk parameters

The NBC 022 is distorting the market agents' databases by mixing the rating (which should serve to identify debtor risks) with the submittal of documents that the SSF currently requires from banking institutions to be able to carry out its supervision.

Thus, a debtor can change his rating several times through the year due to lack of physical documents while his business fundamentals are kept stable over time, or keep an adequate rating based on his supporting documents, but unreal in face of the current conditions of his business, which are still not reflected on the documents requested by the SSF.

It is understandable that the SSF wants to incentivize banking institutions and debtors to comply with the requirements of the law. However, there are adequate prudential tools to enforce the law (fines, sanctions, etc.) that do not affect debtor rating or restrict lending to fulfilling such requirements.

We recommend eliminating from Annex 3 to NBC 022 the third line from the first table containing the necessary parameters to rate business portfolio debtors.

Create a more adequate definition for the business portfolio and the micro-credit portfolio

It is necessary to eliminate Article No. 6 from the NBC 022, and we suggest replacing it with the following text:

> ***"Business Loans"***
> *Article No. 6. Business loans is the total amount of credit granted to companies or individuals whose business purpose is the generation of an organized productive project or activity different from that carried out through micro-credit.*

> ***"Micro-enterprise Loans"***
> *Article No. 7. Micro-enterprise loans is all credit granted to productive units whose annual sales are less than USD$ 50,000 per year."*

A standardization of the SME portfolio needs to be generated because the special technology for this type of portfolio is not compatible with traditional loan granting for corporate credit (which requires less interaction with the client) or with the technique used for micro-enterprise loan (more targeted to co-management).

We suggest the following definition for the different types of business loans, which would complement Article No. 6 of the NBC 022:

> *For the effects of accounting and statistical standardization of the information banking institutions have to report to the supervisory body, the following business portfolio segments are defined as:*
>
> ***Corporate Loans.*** *This is the business credit given to companies or individuals whose annual sales exceed 4,000,000 US dollars.*
>
> ***Medium-sized Enterprise Loans.*** *This is the business credit given to companies or individuals whose annual sales exceed 1,000,000 US dollars.*
>
> ***Small Enterprise Loans.*** *This is the business credit given to companies or individuals whose annual sales exceed 50,000 US dollars.*
>
> *However, banking institutions could keep different definitions to classify these segments in their internal risk systems, as long as they have adequate justification.*

In light of these changes, we suggest modifying Article No. 13, of the NBC 022 in the following manner:

> *Article No. 13. For each debtor, a file containing all legal and financial documents related to the credit application, analysis, approval, and follow-up should be opened, based on the following:*
>
> *For the small enterprise and micro-credit segments of the business credit each banking institution must set forth what documentation for granting loans as well as for their respective evaluation will be required in its policies and this should be subject to review by the Bank Superintendence.*
>
> *For the corporate and medium-sized enterprise segments of the business credit, as a minimum, the information detailed in Annex 2 as well as compliance with policies will be required.*

In addition, NBC 022, Annex No. 1, item 8 needs to be modified as follows:

8) The criteria for rating business portfolio debtors within the small enterprise and micro-enterprise segments must be established in the banking institution's policies and they may be different from the criteria set forth in Annex No. 3, except on the amount of default days which cannot be less strict than those set forth in Annex 3.

Improve risk measurement in the consumption and housing portfolios (Policies and Processes)

It is necessary for banking institutions to include debtor repayment ability measurement and their corresponding credit rating as a mandatory requirement in these portfolios. Even though the system is not yet capable of generating methods for statistical loan granting and monitoring, the SSF needs to include some parameters to guide banking institutions implementing this type of methods, even if they are parametric parameters.

Thus, we suggest the following change to Article No. 17 of the NBC 022:

> *Housing and consumption credit rating*
>
> *Article No. 17. Banking institutions must create loan granting and monitoring systems allowing them to evaluate payment ability for the total amount of housing and consumption credit, based on available information from clients before granting any loans.*
>
> *As a minimum, this system must take into account the debtor's payment behavior, or history this is to say, his default balances the way it is provided for in Annex 1, considering guarantee treatment as provided for in Articles 14 through 16 of these regulations.*
>
> *This does not mean that banking institutions should not evaluate each debtor´s specific characteristics, such as different variables that could affect their payment likelihood. This Superintendence must carry out inspections to ensure the quality of said loan granting and monitoring systems.*

An anti-cyclical policy needs to be created for consumption and housing portfolios

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Even though it is not the objective of this consultancy, we recommend that the SSF evaluates the possibility of implementing an anti-cyclical provision allowing banking institutions to generate some type of savings at times of expansion so that these savings can be used at times of lending contraction.

With a financial system so dependent upon the behavior of international markets, not generating these savings could have serious consequences on the balances of banking institutions specialized in consumption and housing loans.

Some possible options for developing this anti-cyclical fund are found in other countries' regulations. We recommend observing the Spaniard or Colombian experience, but in the short term we suggest implementing a general provision that could be used in times of crisis.

1.2 SSF Projects

In addition to the change suggested in regulation, it is necessary for the SSF to start some type of training on the SME's loan-granting and monitoring systems. In order to reach this goal in the short term, we suggest that some of the SSF's credit risk area's supervisory teams develop and implement adequate training on the SME portfolio realities.

We suggest that the SSF start visiting selected banking institutions to learn about their loan-granting, monitoring, and control systems, as well learning about the new technologies currently being used and the business reality and perspectives within the country.

This information should enhance the development of supervision tools in the future, including risk matrixes, supervision manuals, and statistical models for predicting expected losses.

2. Long Term: Roadmap for the SSF to Implement Supervision-by-risk and the Basel II Standards

Notwithstanding the changes suggested in the short term, the SSF should begin a new path towards modern supervision standards. To this end, we suggest implementing the following roadmap for achieving an institutional project allowing the SSF to migrate towards supervision by risk and implementation of the Basel II standards.

2.1 Definition of Expectations and Timing (Institutional Arrangement)

At this stage, we hope that the SSF and the groups representing SSF agents reach an agreement on what are the expectations of each party in carrying out the change to supervision by risk and implementing the Basel II standards. At this stage, each party's characteristics, advances, weaknesses, and investment capacity to carry out this change must be very clear.

2.2 Development of the Basel II Standards and the Supervision-by-risk Implementation Timetable

With the results obtained in the previous item, the SSF must develop a clear timetable where the steps to implementing supervision by risk and the Basel II standards are clearly detailed. This timetable must include dates and minimum requirements for banking institutions and the SSF to comply with in order to continue with the project.

2.3 Project Development. Training for Supervisors, and Contracting Tools

The SSF must decide on a head to manage the institutional change project. This head must conceive all the project components, including training programs for supervisors, contracting the necessary information tools, inventory of products to be developed and their delivery date, a flowchart, and the functions of SSF officials, etc.

This head must also maintain dialogue with the representatives named by the banking institutions so that the status of the financial system's risk management systems can be evaluated as they are the main input for the projects this person has to manage.

2.4 Create the Necessary Tools for Supervision-by-risk (e.g. matrices, manuals, risk models, etc.)

Supervision-by-risk requires a series of minimal tools to allow its operation. Therefore, the SSF should have working drafts of its risk matrix systems, its supervision manuals, and information tools, before it develops any type of regulation on this issue.

2.5 Know the Risk Schemes of Main Banks

In tandem with item 4, the SSF must being to make regular visits to different banks so that SSF risk supervisors know the risk management systems developed by the financial institutions as a result of the agreement in item 1.

These visits will be the main input for creating norms which include general guidelines and minimum parameters of risk management from the SSF.

2.6 Implementation of Capital Provision Standards

Once risk management systems have been set in place and become operational, the SSF must issue the norms to allow financial institutions to use quantitative models within their risk management systems. This will allow the SSF to enable banking institutions to measure and build up their capital provisions in order to compensate for the risk of implementing businesses.

In addition, the SSF will also have to develop a certain standardized basic calculation quantitative model so as to allow the minimum operation provision for those banking institutions unable to create such a model of their own.

2.7 Implementation of Capital Level Standards

The last step of this project would be the implementation of the minimum levels of capital from the Basel II Accord. To achieve this goal, the banking institutions must calculate their expected loss for a period, based on the guidelines provided in item 6. This will allow the financial system to adequately measure any unexpected losses and the necessary capital level to cover it.

The SSF should include in its regulations all instructions on how to do this calculation and its accounting and prudential implications.